

## Internal Control Failure Analysis of X Industries Co.

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### Abstract

**In October 2021, X Industries Co., Ltd. received a prior notice of administrative penalty and market prohibition from the SFC, and the company's financial statements for two consecutive years were issued with an unavailable audit report by an accounting firm. This article analyzes the main reason for the financial fraud of X Industries Co., Ltd. is the lack of internal control system, therefore, the article analyzes X Industries Co., Ltd. from the perspective of internal control and proposes practical suggestions and measures.**

### Keywords

**Internal control; Financial fraud; Risk prevention.**

### 1. Overview of the background and events of X Industries Co

X Industries Co. was founded in 2016, and the company was able to shift its original main business from producing beer ingredients, fruit and vegetable drinks to selling pharmaceuticals and medical devices, etc. through a major asset restructuring. The company grew by leaps and bounds after its shell listing, with operating revenue growing from 8.99 billion yuan to 10.84 billion yuan in just three years and net profit growth of 11.8%.

In 2019, Company X's performance seemed to be "cut". 2019 revenue was 4.5 billion yuan, down 58.5% year-on-year. Net profit is 98 million yuan, down 81.4% year-on-year. By 2020, operating income will be only 894 million yuan, and net profit will turn from positive to negative loss of 2.2 billion yuan, a decline of more than 2300%. Not only that, in 2019 and 2020 X was issued an unavailable audit report by the firm for two consecutive years.

In April 2020, the Securities and Regulatory Commission (SFC) opened a case against X Industries Co. After a year-and-a-half-long investigation, the SFC found that X Industries Co. had a number of suspected illegal facts, and as a result, X was placed on delisting risk warning.

Among them, the most significant illegal matters were long-term financial fraud and inflated operating income. company X led to an inflated profit by means of inflated operating income and sales expenses between 2016 and 2018, resulting in a cumulative inflated net profit of nearly 2 billion yuan. At the same time, three of its subsidiaries falsely increased revenues by more than 20 billion yuan through fictitious procurement operations and forged bank returns. Secondly, Company X also had information disclosure irregularities and violations. According to the review by the SFC, Company X failed to disclose in a timely manner the connected transactions of non-operating appropriation of funds by the controlling shareholder and its related parties; failed to truthfully disclose the deposit and actual use of the Company's fund-raising funds; and failed to disclose in a timely manner matters relating to the provision of guarantees by the controlling shareholder and its related parties and material litigation.

## 2. Reasons for the Failure of X Industries Co

After the shell listing of X Industries Co., Ltd. achieved rapid development but because the company had inflated operating income, financial fraud, and shareholders' appropriation of funds, it sought too much dominant position. Subsidiaries A and B, among others, had internal control failures, and there were significant deficiencies in capital activities, procurement and sales operations, asset management, and internal controls related to accounting and financial reporting, which affected the preparation of financial statements.

According to the audit report issued by the professional accounting firm, the main bursting point of X Industries Co., Ltd. is the existence of defects in the company's internal control. It is suspected that there are information disclosure violations and has received warnings from the China Securities Regulatory Commission several times; the company has a controlling shareholder and its related parties occupying a large amount of the company's funds that have not been repaid; bank borrowing debts are overdue, etc. All these matters led to the stagnation of the company's operation, significant decline in operating income and rapid deterioration of its financial position. It also indicates that there is significant uncertainty about X Company's ability to continue as a going concern.

## 3. Analysis of Internal Control Deficiencies of Company X

### 3.1. Weak and Flawed Internal Control Environment

Mr. and Mrs. L is the investment holding company of Hubei C, the effective controlling person of Wuhan D, and has absolute control over X Industries Co. through direct and indirect holding. This results in the company's internal control mechanism not being effective as a check and supervision. The excessive shareholder power will make X company too arbitrary and aggressive in making strategic decisions, and the original internal control cannot check and balance this phenomenon.

At the same time, according to the information, X Company Company has the situation that the controlling shareholder occupies the company's funds without repayment. As of December 2020, X Industries Co., Ltd. receivable from the controlling shareholder Hubei C Company Investment Holding Company non-operating funds appropriation of about 1.047 billion yuan, and the period of appropriation of funds from 2016 to 2019, this matter is a serious violation of the relevant provisions of the Securities and Futures Commission.

This shows that the internal control mechanism of Company X is inadequate and there are obvious shortcomings in the corporate governance structure.

### 3.2. Lack of Risk Awareness and Inadequate Assessment at the Decision-making Level

According to the public information of Company X and the investigation of the Securities and Futures Commission, it is known that the controlling shareholder of Company X has been pledging a high proportion of equity for a long period of time. Up to now, Company X has pledged its shares 28 times. For listed companies, the pledging of equity can presume that the company may have insufficient liquidity. However, a high percentage of equity pledges also indicates that the company may have a serious separation of powers and that the company's business risks are high. At the same time, frequent pledging of a high percentage of equity shares, as in the case of Company X, is likely to create a problem of "tunneling" by the majority shareholder, thus exposing the company's interests to encroachment by the controlling shareholder and affecting the company's operating performance and value.

Meanwhile, a review of Company X's financial statements reveals that the company has increased its capital through bank loans and secured loans in addition to equity pledges. The

funds raised are used to repay the relevant arrears and to alleviate the company's cash flow shortage. With this inappropriate leverage with the company, Company X's gearing ratio has increased year by year to 41.04% as of 2020, and the total amount of overdue short-term borrowings exceeds 300 million yuan.

Therefore, it can be seen from the above two aspects that Company X is carrying a high amount of debt and the company has high liquidity risk, the decision-making level has not formulated effective preventive measures for this, and the overall risk awareness is lacking.

### **3.3. Deficiencies in the Accounting Information System**

Company X and its subsidiaries had systemic failures in control activities such as capital activities, procurement operations, sales operations, and accurate and reasonable inventory and accounting for the Company's important operating assets such as inventory. The management of accounting fundamentals was disorganized, and Company X, in order to expand its market share and capture quality customer resources, had greatly increased its credit customers and credit limits without fulfilling the required approval procedures, resulting in a significant increase in accounts receivable. The above matters seriously affected the preparation of Company X's financial statements and the identification of relevant statement items.

### **3.4. Incomplete Information Disclosure and Lack of Effective Communication**

According to the review by the SFC, Company X is suspected of three information disclosure violations, including failure to disclose in a timely manner and failure to disclose in the annual reports from 2016 to 2019 the connected transactions of non-operating appropriation of funds by the controlling shareholder and its related parties; failure to truthfully disclose the deposit and actual use of the Company's fundraising funds; failure to disclose in a timely manner and failure to disclose matters relating to the provision of guarantees for the controlling shareholder and its related parties and material litigation as required.

Company X not only disclosed materially false information in its financial reports to the public, but also announced only the most basic information in its pledge announcement. Company X did not accurately communicate important information related to its main business, which seriously affected the judgment of relevant users in making investment decisions.

### **3.5. Insufficient Internal Supervision**

From the aforementioned analysis, it is clear that Company X has a high concentration of equity. Under this governance structure, it is difficult for other shareholders to form effective checks and balances and supervise the majority shareholder who holds absolute power, so there may be risks of blindness and short-sightedness in decisions involving strategic importance of the company. Secondly, the actual controlling person and management of Company X do not play the role of mutual control and supervision, and the relevant supervisory departments, such as the internal audit department, are null and void and do not play a positive role in the overall internal control of the company.

## **4. Suggestions for Internal Control of Company X**

### **4.1. Improve Internal Control Environment and Optimize Equity Structure**

The design of internal control has a crucial role in the sustainable development of the company, and the reasonableness and effectiveness of internal control on the one hand reflects the company's overall vigilance of its own governance environment, and on the other hand can also reflect the existence of potential business risks from the side, which also provides a worthy reference value point for external investors. The primary reason for Company X's explosion is that the company's internal controls were not in place and management was too insensitive to

the internal control environment. Therefore, the company's primary goal is to raise awareness of the importance of internal controls and create a good internal control environment.

Through the previous analysis of the reasons for the failure of internal control of Company X, it can be seen that there is an over-concentration of equity pledges in Company X, which is not conducive to the long-term development of the company. In order to avoid the riskiness of equity pledges, it is necessary to strengthen the supervision and information disclosure of equity pledges from inside and outside the company respectively, and most importantly, to open up new financing channels to get rid of the dependence on equity pledges.

First of all, quality outside investors can be used and invoked to play a check and balance role on the major shareholders. Not only do quality outside investors take great care and attention to the disclosure of internal information, but they are also likely to introduce advanced management models to the company from the perspective of "onlookers", which can alleviate the company's liquidity problems and improve the company's governance structure.

Secondly, it is also possible to optimize the shareholding structure by increasing the independence of the board of directors and improving the relevant system. The substantial reason for the failure of internal control and the dominance of one share is the serious separation of the two powers, and the deeper reason may be that the shareholder layer violates the principle of separation of incompatible positions and indirectly controls the board of directors by increasing the number of relatives serving on the board. Therefore, the independence and operational efficiency of the board of directors should be improved. To a certain extent, it can effectively reduce the adverse effects of encroachment by major shareholders on the company.

#### **4.2. Strengthen Risk Awareness and Improve Risk Management Capabilities**

Company X ignores the risks, frequently pledges a high percentage of its equity and uses bank loans and secured loans to alleviate the company's lack of capital flow, which exposes the company to excessive operating risks. This "snowballing" approach is a short-term solution, but in the long run, Company X's asset and liability ratio increases year by year.

Therefore, Company X should enhance the risk identification ability of the decision-making level, strengthen the risk awareness of the company as a whole, and shape the risk management culture. Collect relevant information systematically and in a comprehensive manner according to the objectives set. We should analyze the surface and potential risks qualitatively and quantitatively, assess the risk level accurately, and develop a reasonable and effective risk response mechanism, make early warning mechanism and response measures for major key risks, enhance the company's risk prevention ability and improve the company's risk management ability, and strictly follow the relevant system to execute in an orderly manner, so as to reduce the possible risk impact and put the risk in a controllable range. The scope of control.

#### **4.3. Improve the Accounting Information Management System and Authorization and Approval System**

A sound financial accounting information processing and management system is an important foundation for external disclosure and communication. Company X has several subsidiary companies, and thus needs to focus on the financial accounting processing of each department in its capital activities, purchasing operations, and sales operations. The establishment of a sound and effective accounting information management system can effectively guarantee the accuracy of the company's important asset records. For example, when conducting inventory counts to ensure that the procedures are reasonable and the amounts counted are correct, to prevent systematic failures in the control activities of the company's important operating assets, and to improve the effectiveness and accuracy of financial information.

At the same time, a sound and strict authorization and approval system should be established. Each step of the company's development is not only to expand market share and increase operating income, but also to lay the foundation for standing firmly as the industry leader. A strict authorization and approval system can form checks and balances within the company and reduce the situation of blindly granting credit to customers in order to seize customer resources. Establish a hierarchical system of authorization and approval, clarify the authority and responsibilities of each position, and strictly follow the approval system and process for credit authorization management.

#### **4.4. Ensure Accurate Information Disclosure, Timely and Effective Communication**

In the above analysis of the causes, it is clear that Company X has information disclosure violations. Therefore, Company X should improve its information communication and disclosure system and deliver information in a timely manner while ensuring the accuracy of financial information. The disclosure of financial and related information affects the judgment of small and medium-sized investors and the company's own credibility, and true and accurate information can play a positive role for both sides, while false and illegal information can hurt both sides. The establishment of an effective information communication mechanism and a system for collecting relevant internal and external information is the icing on the cake for the company's development. In practice, the transmission and circulation of information are affected by a variety of internal and external factors. A perfect information disclosure and communication system can minimize the dissemination of inaccurate information and improve the negative effects of information asymmetry. At the same time, it can also control and supervise the whole process of relevant business activities, and timely communication brings timely control, thus reducing the possible risks in each link and playing a role in internal supervision and control.

#### **4.5. Strengthen the Supervision and Management System of Internal Control**

Company X's internal control deficiencies revealed significant problems with internal oversight, which was a formality and lacked a scientific management system. The company's internal audit department plays a pivotal role in internal control, and if it is not independent, it cannot maximize its functions. An effective internal control monitoring mechanism can not only detect possible deficiencies in a timely manner, but also force the company to conduct its business activities in strict compliance with laws, regulations and industry rules.

In view of the actual situation of Company X, the company should ensure that the independence and authority of the internal audit department is guaranteed, and that the relevant personnel have excellent professional skills and excellent professional quality, so that they can effectively establish a firm bottom line of supervision for the company. For example, for the company's accounts receivable management issues, internal auditors should review whether the overall process is in line with the company's system standards, whether there is internal fraud and other situations; regularly check whether the use of expenses inside and outside the business is reasonable, etc., timely identify the loopholes in internal control supervision, evaluate and analyze and improve. Establish a sound internal control supervision and management system, improve the internal control supervision system, and provide checks and balances for possible problems such as one share dominance and other risk points.

### **5. Significance of the Case Study**

In summary, the establishment of sound and effective internal control plays a vital role in the sustainable development of a company. Through the systematic analysis of the case X Industry Co., Ltd., it is found that the company's internal control is not functioning, and the disclosure of



internal control information is illegal and irregular. We also analyze the causes of these problems at five levels: the company's internal environment, risk assessment, control activities, information and communication, and internal supervision, and propose targeted recommendations and measures.

The main objectives of the company are to maximize profits, reduce costs, increase efficiency and improve the company's ability to operate. Therefore, it is necessary to establish a series of appropriate and useful standards to restrain the behavior of the effective controlling person to encroach on the company's interests; improve the company's information communication and disclosure system, which not only forms a check and balance within the company and plays a supervisory role, but also ensures that the disclosed information is reasonable, accurate, timely and effective; strengthen the supervision of the company's internal control by increasing the independence of the internal audit department and the authority of the board of directors. Further enhance the company's attention to internal control, and play a guarantee for the legal compliance of the financial and related information provided by the company.

The above proposed measures combined with the case X Industries Co., Ltd. provide, to a certain extent, certain countermeasure guidelines for other companies with similar internal control deficiencies and unreasonable information disclosure.

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